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## &lt;Article&gt;How can we formulate a theory of corporate governance?

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## How can we formulate a theory of corporate governance ?

Mitsuhiro HIRATA

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### Two meanings and two problems of corporate governance

Corporate governance has two meanings. First, it means the relationship between a firm and its stakeholders including shareholders, employees, creditors, competitors, consumers, and so on. Corporate governance in this sense brings us one problem, that is, who owns a firm, to whom it belongs and for whom it should be managed. Secondly, corporate governance signifies the mechanism for checking and monitoring the behavior of top management. Corporate governance in this sense relates to the other problem, namely, from whose standpoint it should be checked and monitored.

### Two purposes of corporate governance

Corporate governance, especially in advanced nations, has two purposes. One is to prevent recurrence of corporate scandals which occurred frequently in Germany, Japan, the UK, and the like from the late 1980s to the early 1990s. the other purpose is to strengthen corporate competitiveness. As to the former, researchers and practitioners treated how a mechanism for checking and monitoring the behavior of top management should be in order to prevent recurrence of corporate scandals. They searched for clues to make a changeover from unlawful management to lawful one. Owing to their efforts, most of corporate scandals have been dispelled in those nations except Japan, where their greatest concern of late has been how to enhance corporate competitiveness. Conversely in Japan, corporate scandals went on and on until quite recently. Japanese researchers and practitioners came at last to find out means to strengthen corporate competitiveness. As for the latter, they are grappling with a mechanism for making speedy and accurate decisions so as to do a change-over from inefficient management to efficient one.

## Four rising problems before us at the beginning of the twenty-first century

### 1 To formulate a theory of corporate governance

Since 1990 corporate governance problems have been eagerly and rapidly studied by many researchers both at home and abroad in the fields of accounting, economy, finance, law, management, and so on. Many fruitful results have been obtained from their efforts. However, they have never attempted to formulate a theory of corporate governance. So above all things we need to tackle this task straight on. I will present an essay on it later.

### 2 To make an international comparison of key concepts on corporate governance

Before we begin to formulate a theory of corporate governance, we need to make an international comparison of key concepts on corporate governance, such as: viewpoint on a firm and its objective; top management; management mechanism; corporate law system; the relationship between a firm and its stakeholders; structure of shareholding; accountability; disclosure; and so forth. Concerning some of these concepts, comparative studies have already yielded considerable fruit. However, we need to deepen our comparative studies about them all still more.

### 3 To clarify some fundamental concepts on corporate governance

Corporate governance problems have been studied interdisciplinarily, but academic exchanges among related social sciences including management, law, economy, finance, accounting have not been conducted. Therefore, we have not yet reached a real consensus on the concept of corporate governance. In order to make this concept clear, the relationship among governance, compliance and business ethics must be clarified. Moreover, the object of our studies is even now unclear. Whether we should only deal with the governance issue of a firm or not must be made clear.

### 4 To build up a corporate governance system

Reforms of the corporate governance system that occurred in advanced nations in the 1990s, especially in Japan, have placed particular stress on accountability rather than on performance. First, how to build up the corporate governance system which can realize sound and efficient business management. Secondly, how to establish the corporate governance system which can be globally accepted, confronting with the trend of a borderless economy and globalization of business activity. Thirdly, whether corporate governance systems of every country will converge into one system in the long run or not must be considered.

## How can we formulate a theory of corporate governance ?

I present here an essay on corporate governance. In my opinion , the theory of corporate governance is practical as corporate governance forms the core of the firm. It consists of eleven research areas:

### 1 The market economy system and corporate governance

Diversifying market economy system, such as the former socialistic countries, developing countries, and advanced countries present unique characteristics and problems for corporate governance and its study.

### 2 Corporate law system and corporate governance

In this topic, what role the corporate law system as an institutional basis for corporate governance plays must be made clear.

### 3 Corporate form and corporate governance

In this topic, the characteristics and problems of corporate governance in single individual firms such as public limited company , private limited company, and so on, versus those of group corporate governance, represented by firms such as Kigyoshudan , Kigyokeiretsu, and so on must be clarified.

### 4 Corporate control and corporate governance

In this topic, the relationship between corporate control and corporate governance, and the common points and different points between corporate control and corporate governance must be clarified. Additionally, the managerial characteristics of corporate governance under the control of shareholders, banks, management, and so on must be made clear.

### 5 Business ethics and corporate governance

In this topic, the relationship among business ethics, corporate governance and compliance must be clarified. Moreover, the ethical significance of a lack of business ethics and the compliant mind syndrome, the so called moral hazard, in what often brings about top management corporate scandals, and so on must be clarified.

### 6 Viewpoint on a firm and its objective and corporate governance

As for the viewpoint on a firm , there are several opinions, namely, shareholder theory, stakeholder theory,

agency theory, proprietorship theory, and transaction cost theory. Concerning the viewpoint on its objective, several views can also be found, that is, profit maximization of shareholders or the firm, maximization of interests of stakeholders, profitability and social responsibility, and so on. What impact these views on a firm and its objective will have on how to understand corporate governance must be made clear.

## 7 Top management and corporate governance

In this topic, the concept of top management, its type, function, and role, the legitimacy to exercise its authority, the checking and monitoring of its behavior both from inside and outside of the firm by the internal control system, market for corporate control, stock market etc., the accountability of top management, its evaluation and reward, the transparency and disclosure of its behavior, and so on must be examined.

## 8 Management mechanism and corporate governance

In this topic, how much the management mechanisms like annual meeting of shareholders, board of directors, board of auditors, and so on, and various committees within the board worked in the past, and how much they will work in the future must be examined.

## 9 The structure of shareholding and corporate governance

In this topic, what role institutional investors, employee stock ownership plans, foreign shareholders etc. have played in corporate governance, and what impact they are making on corporate governance must be clarified.

## 10 Corporate competitiveness and corporate governance

In this topic, how much competitiveness German management, Japanese management, American management, European management, Asian management, and the like have in corporate governance must be investigated.

## 11 International comparison of corporate governance systems

In this topic, such important key concepts in corporate governance as viewpoint on a firm, viewpoint on its objective, top management, management mechanism, corporate law system, stakeholder relations, structure of shareholding, accountability, disclosure, and the like must be compared internationally. Moreover, the possibility of convergence of corporate governance systems or their global standardization, the possibility to build up global standards or code of best practices of corporate governance, and the like must be considered.

Among these eleven research areas No.7, 8 and 11 are the principal ones. No.5, 6 and 9 come next to these. The relationship between the theory of corporate governance and related social sciences can be shown as follows.

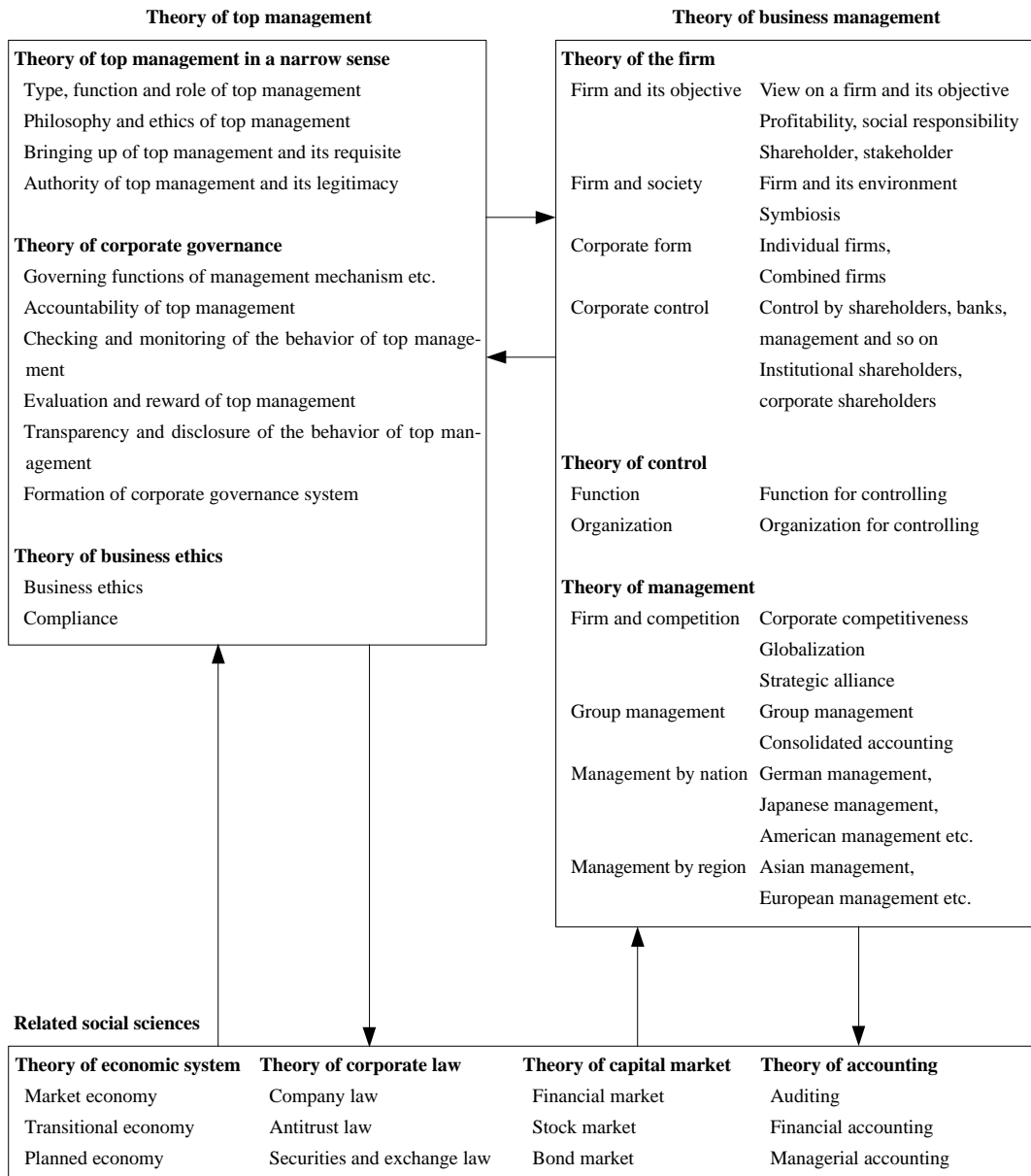


Figure 1 The relationship between a theory of corporate governance and related social sciences

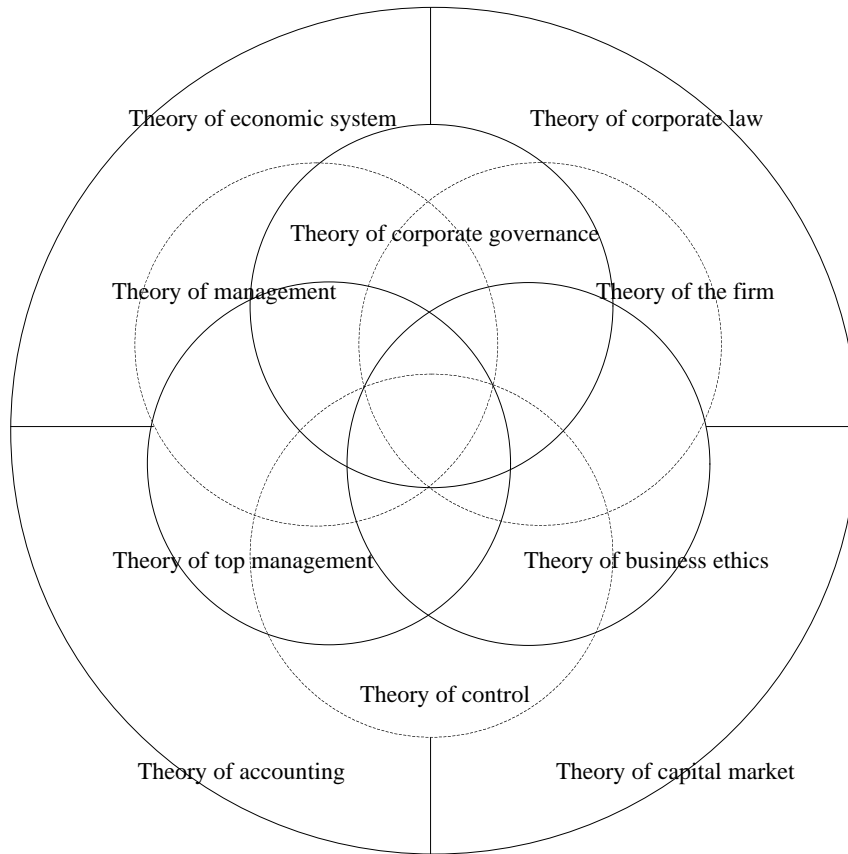


Figure 2 The relationship between a theory of corporate governance  
and related social sciences

## Appendix

### Main legal reforms on corporate governance since 1990 in Japan

- a. 1990 The minimum regulatory capital requirement program was introduced.
- b. 1993 The corporate auditor system was strengthened.
- c. 1993 The shareholder lawsuit was relaxed.
- d. 1997 The ban on holding companies was lifted.
- e. 1997 The stock options program was introduced.
- f. 1997 The ban on illegal payoff was intensified.
- g. 1999 The exchange or transfer of shares program was introduced.
- h. 2000 The split-up of company program was introduced.

Legal reforms for preventing recurrence of corporate scandals triggered No. b, c and f.

Legal reforms for strengthening corporate competitiveness led to No. d, e, g and h.

### Some proposals on corporate governance reform by several institutions of late in Japan

#### Proposals for making reforms of the board of directors

- 1 The functions of board of directors should be separated so that the function of decision-making and supervising and that of executing are clearly distinguished.
- 2 The number of directors should be appropriate to guarantee effective discussion at board-level, and to enhance accurate, timely and speedy decision-making.
- 3 The board of directors should actively include independent, non-executive directors.
- 4 Executive directors should have joint information with non-executive directors who are supported by a system to provide necessary information.
- 5 Several committees, such as nomination committee, remuneration committee, and so on should be established within the board.
- 6 The mandatory retirement age or the term of office program should be introduced in order to infuse new blood into the board.

#### Proposals for making reforms of the board of corporate auditors

- 1 The quality of corporate auditing should be improved by the appointment of more than one independent external auditor, and also by more carefully defining the role of him or them vis-a-vis internal auditors.
- 2 The neutrality of the auditing function should be ensured by selecting corporate auditors only with the full consent of the board of corporate auditors itself.
- 3 In order to make the auditing by corporate auditors more effective, the member of auditing staff supporting them should be increased and strengthened.
- 4 An audit committee should be created within the board of directors as soon as the majority of the auditors are independent and non-executive. It may lead to the abolishment of the board of corporate auditors.



**Proposals for making reforms of the shareholders meeting**

- 1 The general shareholders meeting should be utilized to enhance the scope of dialogue between shareholders and the board of directors. This is desirable to promote the quality of director's accountability.
- 2 The general shareholders meeting should be staggered.
- 3 Resolutions submitted for decision at the general shareholders meeting should be limited to those which are of vital importance to the business, for example revision of corporate articles, transfer of business, M & A which require a three quarter majority special resolution of the shareholders, and the election of directors and corporate auditors.

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